

THE BALANCING ACT

FUND COMPANIES WEIGH IN ON MANAGING EXPENSES IN A TURBULENT MARKET

MARCH 2009

INTRODUCTION

WITH DECLINING ASSETS ACROSS THE FUND INDUSTRY

over the past several months, we have witnessed growing concern among asset managers and fund boards of directors/trustees regarding peer comparability and industry best practices for the 15(c) renewal process during 2009.

Much of the current problem stems from the fact that fund expenses, as reported in each fund's most recent annual report, reflect a fund's expenses over a one-year period, rather than a forward-looking expense run-rate. Given that assets for nearly all equity funds have declined substantially, many funds may not be able to maintain historical expense ratios. This creates a set of unique challenges that fund boards must consider when assessing a fund's fees.

In order to get a better gauge of how industry participants are reacting to some of these issues, Lipper sent a survey to all of our fiduciary services clients and asked for their responses to a set of questions based on this issue. We received completed surveys from 64 distinct fund complexes, representing roughly 25% of all industry assets. Respondents ranged in size from single-fund boutique shops to some of the largest fund complexes in the business.

Lipper's Fiduciary Research Team is committed to providing the most current, timely, and relevant industry intelligence related to fund expense ratio analysis and other related topics. This document attempts to aggregate some of the opinions and practices from around the industry. The issues discussed in the next few pages expand upon such topics as fund expense caps, firm profitability, assessing fees in a challenging environment, and expense ratio reporting. Lipper intends to continue to publish updates on this topic as new data becomes available over the next several months.

KEY POINTS:

- There are a number of new issues affecting discussions between fund advisors and boards over the past several months. Many of these issues are directly related to the substantial drop in assets under management for many firms.
- The most difficult expense component for boards to evaluate during the 2009 15(c) contract renewal process is expected to be nonmanagement expenses, exclusive of transfer agency and custodial expenses.
- A majority of fund firms have indicated that they do not expect to restate total expense ratios for their funds in upcoming prospectus releases.
- Both advisors and fund boards are concerned about the stability and marketability of money market mutual funds in the current low-interest-rate environment.
- A majority of fund boards are unlikely to approve increased expense caps, despite the decrease in assets that most funds have experienced.
- Complex profitability is not a key consideration in setting expense caps for a majority of fund complexes.
- There is increasing interest among fund boards to assess the portfolio risk characteristics of the funds under their fiduciary umbrella.

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EXPENSE CAP DETERMINATION

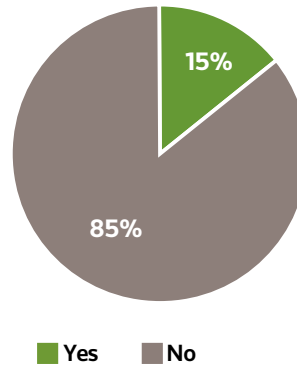
The survey results reveal that the vast majority of fund boards do not base their expense caps on an algorithmic calculation methodology such as setting each fund's expense cap equal to a set percentile derived from Lipper peer data (Figure 1). However, for those fund complexes that do not use a predetermined algorithm, peer competitiveness remains the primary determinant for expense caps. Lipper peer groups were the most cited set of peers used for determining appropriate expense cap levels. Several complexes also take into consideration the competitiveness of the peers that are distributed on the same platform or are determined to be direct marketplace competitors. Peers from within the fund complex are also examined, suggesting that some complexes strive to achieve similar pricing structures across the complex, with less regard to factors affecting individual funds.

Many fund complexes listed a set of qualitative factors in addition to quantitative analysis in the process of setting expense caps. Service levels, advisor profitability, and simple business judgment are all considered in the determination of expense caps. Input from fund advisors and individual board members is also valued very highly by a number of complexes.

Complex profitability does not appear to be a driving factor in the determination of expense caps for most complexes. Only 34% of reporting complexes indicated that complex profitability is at least somewhat important in the determination of expense caps, with only 11% of reporting complexes indicating that complex profitability has been more than an ancillary consideration with respect to fund expense caps (Figure 2).

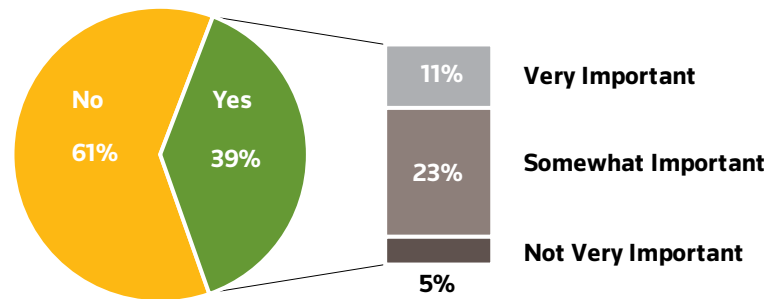
Survey responses were split between whether overall complex profitability or individual fund profitability was more of an issue for fund boards. We note that three very large fund complexes indicated that, while complex profitability is not a factor in the determination of expense caps, the profitability of individual funds is a factor. Two of these firms are subsidiaries of major bank holding companies that also derive revenue from sources outside of their asset management business.

FIGURE 1 COMPLEXES THAT SET EXPENSE CAPS USING ALGORITHMS



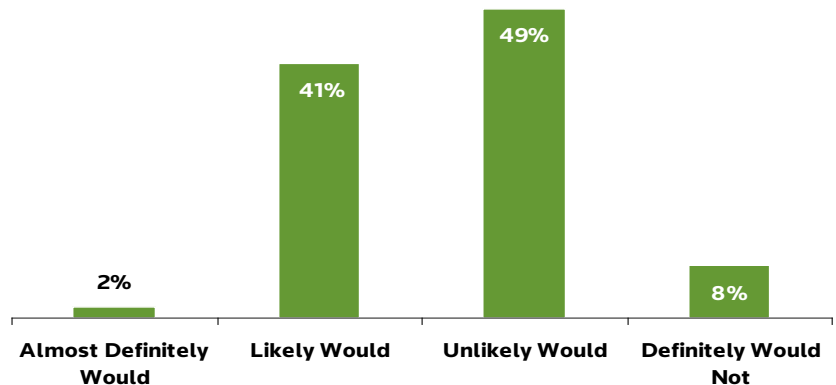
The percentage of fund complexes that indicated that expense caps are determined using an algorithmic methodology (such as setting fund expense caps equal to the 60th percentile of the Lipper expense universe).

FIGURE 2 DOES COMPLEX PROFITABILITY AFFECT EXPENSE CAPS?



The number of fund boards that take complex profitability into account when setting or approving expense caps. Of the complexes that take profitability into consideration, the bar chart on the right describes how important the profitability is with respect to expense cap determination.

FIGURE 3 BOARD APPROVAL OF EXPENSE CAP INCREASES



The results of the survey question that asked how advisors believed their fund boards would respond if asked to approve higher expense cap levels for the funds.

There were a wide range of responses regarding perceived board responses to proposed increases in expense caps. While a majority of respondents indicated that their boards would be unlikely to or would definitely not approve an increase in expense caps, 43% of firms estimated that they would have little or no trouble raising the expense caps that are currently in place, given the recent decline in fund assets. For this question, respondents could select only from the four responses listed in Figure 3.

With respect to board concerns regarding changes to existing caps, the most frequently cited issue was the concern about shareholder perceptions of fee increases. Many firms believe that increases in fees would not be well received by fund shareholders; in fact, some have even suggested that increases in caps could lead to increased redemptions. The second most cited concern was the competitive positioning of the funds from an expense perspective, while a third common concern was related to advisor profitability issues.

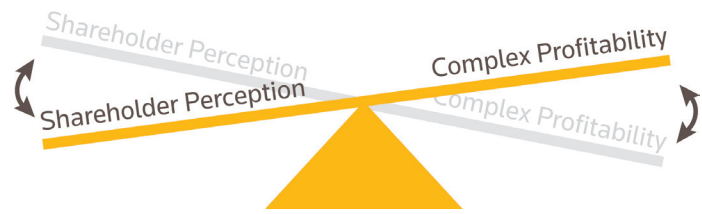
We followed with an open-ended question regarding board concerns with respect to proposed increases. Among the respondents that indicated that increased caps would unlikely or definitely not receive board approval, 55% of survey respondents were concerned about their

“The board will look at [the expense ratios of] the peer group, size of the fund, age of the fund, the average account size of the accounts in the fund, and the quality and nature of services provided.”

shareholders' perception of a fee increase. Firms that expected that a proposed increase would not receive substantial push-back were most concerned with the market competitiveness of the funds. For the single firm that indicated that the board would almost definitely approve increased expense caps, a substantial decrease in overall firm profitability was cited as the primary board concern. Decreases in firm profitability were also seen as more of a concern for firms that responded that increased caps likely would be approved than for those firms that indicated that cap increases would likely not be approved. None of the firms that said cap increases would definitely not be approved listed profitability as a board concern.

One of the largest fund complexes that responded to our survey indicated that in scenarios where the expense ratio of a fund is determined by the board to be high, the board typically reviews a number of quantitative and qualitative factors when setting an expense cap: “The board will look at [the expense ratios of] the peer group, size of the fund, age of the fund, the average account size of the accounts in the fund, and the quality and nature of services provided.”

FIGURE 4 BALANCING THE SCALES



Although this response is somewhat generic, given our level of experience, industry research, and discussions with industry participants, we can assume that the interrelated components of this quote can be interpreted as follows:

EXPENSE RATIOS OF THE PEER GROUP

Many fund complexes set their expense caps relative to some appropriate benchmark, and in many cases, the benchmark used for comparison is a peer group. Expense ratios of the peer funds are often used to establish some descriptive statistics, such as averages and medians that are then compared to the fund in question to determine the relative positioning of the fund.

SIZE OF THE FUND

Lipper research has demonstrated that economies of scale are perceived to exist within the fund industry. This means that, all else held constant, we would expect a smaller fund to have higher operating costs than a larger fund. A higher expense ratio could be appropriate for a small fund, given the smaller asset base over which to spread out any fixed costs.

AGE OF THE FUND

We assume that the age of the fund is partially related to the size of the fund issue discussed above, in that a newer fund is less likely to have accumulated an asset level whereby it would begin to benefit from economies of scale. In addition, prior Lipper research has shown that newly released funds are more likely to have breakpoints in their management fee schedules from inception than older more established funds, for which breakpoints were often implemented as the fund grew in size. In many cases older funds implemented breakpoints as these economies were realized, whereas newer funds estimate where the economies will occur and institute the breakpoints from the outset.

AVERAGE ACCOUNT SIZE

A number of fund expenses are charged based on the number of accounts, not necessarily the fund's assets. In cases where the average account size of a fund is small, per account fees, as a percentage of fund assets, will be relatively high. Again, holding everything else constant, a fund with smaller account sizes will often have higher expenses than a fund with larger account sizes. This issue is discussed in greater detail in the next section.

QUALITY AND NATURE OF SERVICES

Obviously, there are costs inherent in the services that a fund provides. A fund that provides more and/or higher-quality services to shareholders will typically incur higher expenses than a fund that provides fewer and/or lower-quality services. This often results in a tradeoff between shareholder services and fund expenses.

2009 15(c) CONTRACT RENEWAL PROCESS

Although most survey respondents indicated that additional board requests to supplement data are currently unknown or not expected for the 2009 15(c) contract renewal process, a number of complexes indicated that they will be providing their boards with more in-depth peer group expense analysis and white papers regarding industry trends. Some of the most commonly cited supplemental data related to expense caps, expense trends, and profitability. Some of the less frequently mentioned topics included data regarding decreases in assets under management across the industry and information on mergers and liquidations over the past months.

For the few complexes with boards that have already requested additional information for the 2009 15(c) contract renewal process, according to our survey, this information has largely been in one of two distinct categories: (1) competitor information, and (2) fund information. Some of the requests for each of the two categories are listed below.

(1) COMPETITOR INFORMATION

- Current management fee ratios for peer funds
- Updated supplemental peer expense data

(2) FUND INFORMATION

- Projected (pro forma) expense ratios
- Current run-rates
- Portfolio attribution and risk analysis

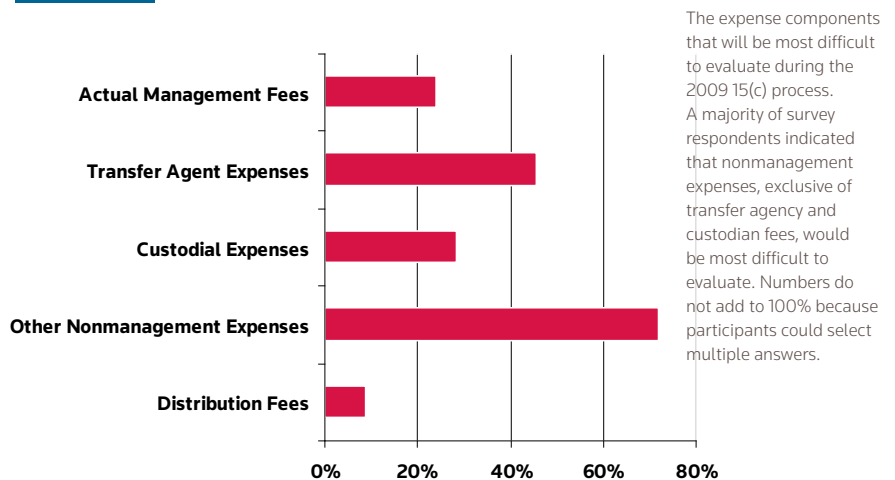
FIXED COSTS CREATE DIFFICULTIES FOR EVALUATION

Our survey also included a question regarding which particular expense components will be most difficult for boards and advisors to evaluate during 2009 given the substantial drop in assets experienced by most equity funds. Although transfer agency and custodial

FIGURE 5 FIXED EXPENSES INCREASE AS AVG. ACCOUNT SIZES DROP



FIGURE 6 DIFFICULT TO EVALUATE EXPENSE COMPONENTS



The expense components that will be most difficult to evaluate during the 2009 15(c) process. A majority of survey respondents indicated that nonmanagement expenses, exclusive of transfer agency and custodian fees, would be most difficult to evaluate. Numbers do not add to 100% because participants could select multiple answers.

expenses were deemed to be difficult to evaluate by a number of complexes, the most common response was that other nonmanagement expenses, exclusive of transfer agency and custodial expenses, would be the most difficult from a fee evaluation perspective (Figure 6). Many of these expenses consist primarily of a fixed cost that will increase on a percentage basis as assets drop. A few specific examples of these components include legal and audit fees, fund accounting, and postage and printing fees. For an example of this, let's envision a scenario where it costs \$1 to print and mail a prospectus to an investor with a \$10,000 account—a charge of one basis point. However, because that same account now has only \$5,000, the same \$1 charge has now become an expense of two basis points. Only 7% of respondents expect any restructuring, either temporary or permanent, of per-account fees during 2009.

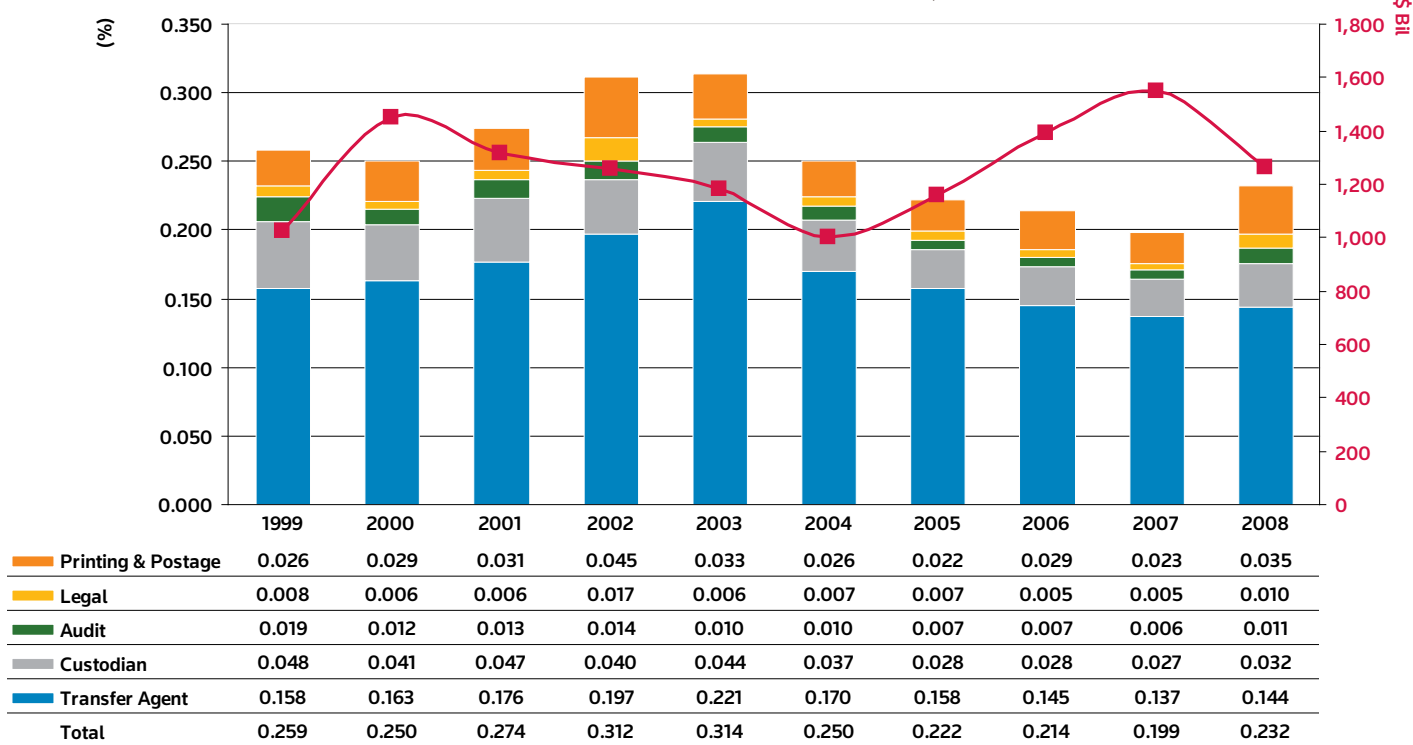
Acknowledging that some of these components will be more difficult to assess during 2009, we note that most complexes expect that peer group analysis will remain the most popular starting block for expense analysis. Several firms indicated that they expect to supplement the data that is available for peers with a comparison of historical expenses—an example of historical data that a board might use in evaluating historical fees is shown in Figure 7. The chart illustrates the general trend that in periods where large-cap equity fund assets were declining, nonmanagement expense ratios experienced relative increases.

It also appears that a number of boards will be presented with supplemental pro forma expense data and current run-rates for the funds in question during the 2009 process. In our experience, we note that boards are increasingly being presented with risk analysis for their funds as well.

We asked our participants to list some of the unique issues that they expect to arise during the 2009 15(c) cycle from both the perspective of the board and the perspective of the asset manager. The question was open-ended, and we list some of the most frequently noted issues from the perspectives of both the fund advisors and the boards:

**FIGURE 7 HISTORICAL NONMANAGEMENT EXPENSE EXAMPLE
LARGE-CAP EQUITY FUNDS**

Expense ratios are represented by the left axis, while average net assets are shown on the right axis and represented by the floating red boxes. As fund assets declined over the two-year period from 2001 to 2003, nonmanagement expenses, on average, increased substantially. Data from 2008 is estimated based on the data currently available (85% of reporting funds).



BOARD CONCERNS REGARDING 2009 15(c) CYCLE

1. Availability of appropriate comparison data for peers and fund industry
2. Firm financial stability - including the financial stability of any subadvisors
3. Stability and marketability of certain money market funds in a low-interest-rate environment. Also the effects and impacts of the Treasury money market fund guarantee program
4. Use of derivatives and risk-management techniques used by the funds
5. Closed-end bond fund leverage concerns regarding the market for auction-rate preferred shares

ADVISOR CONCERNS REGARDING 2009 15(c) CYCLE

1. Advisor profitability - including fees derived from affiliated and third-party service providers
2. Peer fund expense comparability and availability of appropriate data for benchmarking
3. Money market fund stability and marketability

PROSPECTUS EXPENSE RATIOS

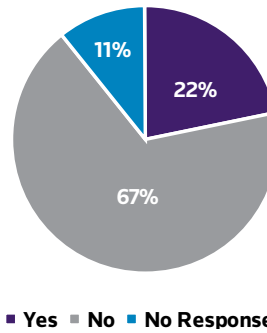
As noted in prior Lipper research¹, we have seen little consistency throughout the industry as to how funds are reporting expense ratios in recently released and upcoming prospectuses. Our survey asked whether fund companies expect to restate the expense ratios in the prospectuses. Most complexes indicated that prospectus expense ratios would not be restated, although 22% indicated that they do expect to restate their expense ratios.

Of those fund complexes that do not plan to restate prospectus expense ratios, the most common reason for not reporting an increase in expense ratios was that an expense cap that is already in place will prevent an increase in expenses. This was followed in frequency by complexes indicating that they are unable to determine at this time whether expenses will increase (Table 1).

For the group of complexes that do anticipate revising expense ratios in fund prospectuses, 36% said that they would report current run-rates for their funds, while the same number expected to report the expense ratio from the most recently released annual report with a footnote describing the recent decrease in assets and related anticipated increase in total expense ratio (Table 2).

¹"Expenses in a Downturn" – Lipper, 2009

FIGURE 8 PROSPECTUS EXPENSE RATIO RESTATEMENTS



The percentage of respondents that indicated they are expecting to restate prospectus expense ratios given the loss of fund assets.

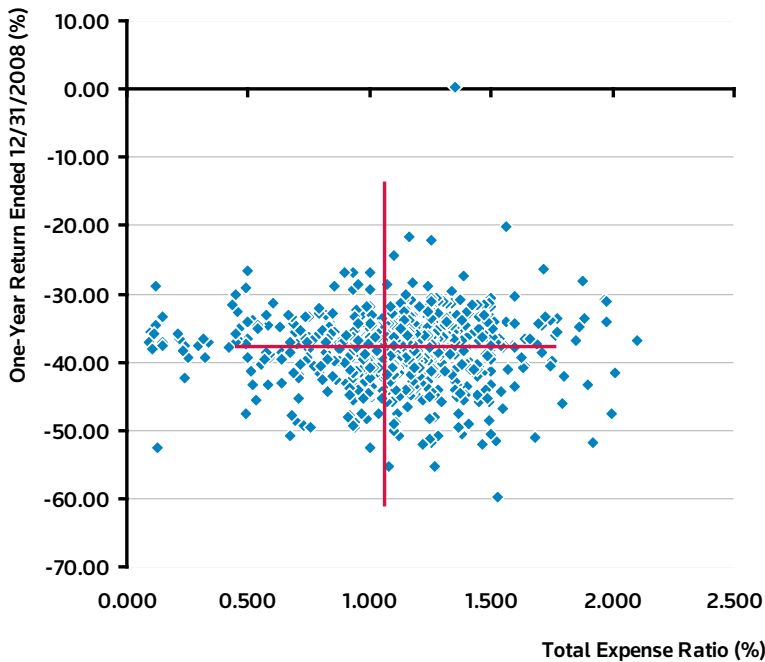
TABLE 1 REASONS FOR NOT RESTATING PROSPECTUS EXPENSE RATIOS

1 Do not expect expenses to increase due to decreased assets	12%
2 Expense cap already in place will prevent an increase	58%
3 Voluntary waivers will keep expenses at current level	23%
4 Unable to determine at this time if expenses will increase	33%
5 SEC advised not to increase reported expenses in Form N1A	9%

TABLE 2 DETERMINING REVISED EXPENSE RATIO TO REPORT

1 Report current run-rates	36%
2 Report expense ratio from last annual report with footnote noting a decrease in assets and anticipated increased TER	36%
3 Report based on new expense cap already in place	21%
4 Report based on anticipated expense cap	29%

FIGURE 9 PERFORMANCE VS. EXPENSES



One-year returns and total expense ratios of all open-end front-end load and no-load large-cap equity funds.

ADDITIONAL CONSIDERATIONS

Although loosely referenced by survey participants, in our discussions with some of the firms that did not respond to our survey, we note that fund complexes are increasingly presenting boards with additional analysis and tools. In this section we present a couple of the tools that we believe boards may find useful in their analysis of their funds with respect to some of the topics discussed in this document.

Boards and their advisors might use these proposed metrics or similar data in determining relative performance for their funds for the purposes of peer evaluation.

PERFORMANCE VS. EXPENSES

A number of survey respondents indicated that one of the determinants in setting a fund's expense cap is its performance history—suggesting that caps might be set at higher levels for a fund that has consistently outperformed its peers. One way for boards to evaluate funds against this criteria is to compare a fund's returns against its expense ratio. We have provided a sample version of this analysis in Figure 9.

The Performance vs. Expenses chart illustrates the one-year returns and most recent total expense ratios for all open-end front-end load and no-load large-cap equity funds in the Lipper database. The red crosshair indicates the average one-year return and average expense ratio. Funds plotted above the red line have better-than-average performance, while funds plotted to the left of the line have lower-than-average expense ratios. This type of analysis can be useful to fund boards and advisors when setting expense caps.

RISK/RETURN ANALYSIS

Lipper is also receiving more requests from both boards and fund companies for data relating to portfolio risk measures relative to peers. In Figure 10 we plot the beta for each large-cap core fund in the Lipper database as of October 31, 2007, when fund industry assets peaked. This is compared against the returns that the funds have generated since that date; each blue diamond represents one fund. We see that the higher-risk (high beta) funds lost more, on average, than the lower-risk (lower beta) funds in the recent market downturn. This relationship is consistent with what we would expect. Fund boards

FIGURE 10 PORTFOLIO RISK ANALYSIS EXAMPLE

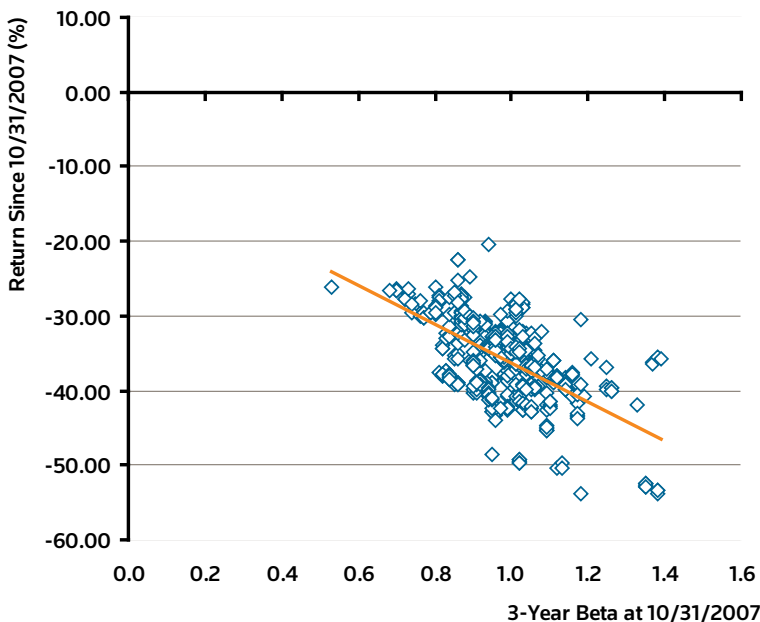


Figure 10 illustrates a sample risk analysis chart. It examines each fund's three-year beta, relative to the S&P 500 Index as of 10/31/2007 (the month when fund industry assets peaked), and its return since that date. The data shows a relationship that is consistent with our expectations.

Beta is a measure of a security's expected return in relation to the overall market, measured by the relevant performance benchmark.

may use this information to help gauge a fund's performance, relative to its risk profile. A fund that plots above the orange line has generated returns greater than those that were expected, given its beta. A fund below the line has generated a lower return than expected. This difference between each fund and the regression line is called alpha.

It is important to be aware of the causes for the returns that a fund has generated. There is a distinction between a fund that generates low returns due to poor security selection and a fund that generates low returns because its investment strategy (underlying asset class) is currently out-of-favor. There may be many factors influencing the performance results of a fund.

CONCLUSION

We have presented a number of the issues that will be at the heart of fund board/asset manager discussions during the 2009 contract renewal season. There are clearly some unique challenges this year that will need to be considered during the process.

Although our hope in conducting this survey was to uncover some proactive strategies for fee analysis given the current market conditions, we ultimately came to the conclusion that most firms are struggling with the same topics. The majority of the approaches we have witnessed can be described as reactive. While differing opinions exist, it appears that many companies are all struggling with similar issues. Most firms do not yet know the net effect on fund expense ratios, and of the few that do, only a handful were able to provide any rough estimates of the magnitude of the changes.

Although some difficulties are bound to arise during the 15(c) contract renewal process, Lipper believes that there is sufficient information available to allow participants to make informed and relevant decisions regarding fund expense ratios. An analysis of peer groups provides a solid starting point for the analysis, realizing the limitations of the available data on peers. Given that assets have changed substantially from prior years, it may be appropriate for boards to place additional emphasis on expense universes, which represent a wider cross section of data and normally include all funds of a given load-type in a Lipper investment classification, regardless of asset size. This information might be supplemented with information regarding changes in the average account sizes of the funds. The inclusion of historical fund expense data, while not a perfect proxy for current fund market conditions, can also help to provide information on the behavior of fund expenses during previous market downturns.

FUTURE RESEARCH ON THIS TOPIC

One of the themes apparent in the results of our survey is that fund boards and asset managers are looking for more industry research on this topic. Lipper's Fiduciary Research Team expects to continue to publish relevant intelligence on this topic as it becomes available. Look for future Fiduciary Research in the coming months.

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